

MORTGAGE

BACKED

SECURITY

What to Know About Mortgage-Backed Securities

Could be compelling for investors now, but know the risks and rewards

Mortgage-backed securities (MBS) are an important investment tool for those looking to extend duration and reduce reinvestment risk, particularly in the current economic climate where yields remain high. As the Federal Reserve considers cutting rates, understanding MBS becomes even more crucial. Here's a guide on what investors need to know about MBS and why they should be considered now.

Understanding Mortgage-Backed Securities

Mortgage-backed securities are investments backed by a pool of mortgages. These securities offer a way for investors to gain exposure to the mortgage market without directly owning the mortgages themselves. When homeowners make their mortgage payments, the cash flows are distributed to MBS investors.

Unique Characteristics of MBS

1. **Prepayment Risk:** Unlike traditional bonds, MBS have the unique characteristic of prepayment risk. Homeowners can pay off their mortgages early, particularly when interest rates fall, which can lead to a return of principal earlier than expected.
2. **Duration Extension:** MBS typically have an average maturity of 30 years, but prepayments can significantly shorten this duration. For investors looking to extend the duration of their portfolios, MBS can help balance reinvestment risk by offering potentially higher yields over a longer period.

3. **Yield Comparison:** Historically, MBS yields have been higher than those of U.S. Treasuries, reflecting the additional risks involved. In the current market, this yield premium can make MBS particularly attractive.



Why Consider MBS Now?

1. **High Yields:** With the Federal Reserve maintaining high interest rates, MBS yields have remained elevated. This environment provides an opportunity for investors to lock in higher returns.
2. **Duration Management:** Extending duration has been a key strategy for many investors. Short-term yields, such as those from Treasury bills or money market funds, tend to move with the federal funds rate. While Treasury bills with maturities of six months or less currently yield above 5%, these rates are expected to fall once rate cuts begin.

3. By extending duration through MBS, investors can reduce the need to reinvest at potentially lower rates.
4. **Reinvestment Risk Mitigation:**
Reinvestment risk occurs when maturing investments need to be reinvested at lower yields. MBS, with their longer durations, can help mitigate this risk by providing steady, higher yields for a longer period, thus protecting income streams against declining rates.

MBS Yields vs. Other Investments

In today's market, MBS yields are competitive compared to other high-rated alternatives. While U.S. Treasuries are considered the safest investment, their yields can be lower compared to MBS. Investors looking for higher returns might find MBS to be a suitable alternative, especially given their risk-adjusted yield advantages.

Know the Risks & Rewards

Mortgage-backed securities offer a compelling option for investors seeking to extend duration and reduce reinvestment risk in a high-yield environment. Their unique characteristics and current yield premiums make them an attractive investment, particularly as the Federal Reserve's rate cuts loom on the horizon.

As with any investment, understanding the risks and rewards of MBS is crucial.

By considering MBS now, investors can potentially secure higher yields and manage duration more effectively in their portfolios.